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No.

IN THE SUPREME COURT

OF THE

UNITED STATES

OCTOBER TERM, 1982

PAUL F. KENDRICK,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether the criminal sanctions of Section 10(b) of the Securities Exchange Act of 1934 will be extended to cover every fiduciary breach by a stock broker.

2. Whether the criminal sanctions of Section 10(b) of the Securities Exchange Act of 1934 will be extended to a breach of fiduciary duty where a broker or other fiduciary withdraws funds from another financial institution on a customer's credit to cover the checks of the broker.

3. Whether the courts will still require that before the criminal sanctions of Section 10(b) of the Securities Exchange Act of 1934 there must be proof that the acts of the defendant stock broker constituted a fraud in connection with the purchase or sale of a security.

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Paul F. Kendrick respectfully petitions this Court for a writ of certiorari to review the decision of the United States Court of Appeals for the Ninth Circuit filed November 22, 1982.

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is not yet officially reported. It is reproduced and appended hereto as Appendix A. The judgment of the United States District Court for the Northern District of California is unreported. It is reproduced and appended hereto as Appendix B.

JURISDICTION

The opinion of the Court of Appeals for the Ninth Circuit was filed on November 22, 1982. The order denying rehearing was filed on December 20, 1982. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED

15 U.S.C. § 78j(b):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce or of the mails,

or of any facility of any national securities exchange -

* * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may proscribe as necessary or appropriate in the public interest or for the protection of investors."

17 C.F.R. § 240.10b-5:

"§ 240.10b-5 Employment of manipulative and deceptive devices.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of

> the circumstances under which they were made, not misleading, or
>
> "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> "in connection with the purchase or sale of any security."

STATEMENT OF THE CASE

On August 19, 1981 the defendant Paul F. Kendrick was indicted in two counts for violation of the securities laws and in two counts for perjury. On August 26 a superseding indictment was returned adding one more count of securities fraud.

In the first count, the indictment charged that Mr. Kendrick on August 23, 1976 converted to the use of Kendrick & Co., a corporation engaged in the stock brokerage business of which Mr. Kendrick

was president, customer funds of Laurence L. Spitters in the amount of $150,000.

In the second count, the indictment charged that Mr. Kendrick on September 23, 1976 converted to the use of Kendrick & Co. customer funds of the Congregation of the Passion, a Roman Catholic religious order, in the amount of $104,931.86.

In the third count, the indictment charged that Mr. Kendrick on September 8, 1976 converted to his own personal use customer funds of the Congregation of the Passion in the amount of $27,000.

In the fourth count, the indictment charged that Mr. Kendrick on January 23, 1978 swore falsely before the Securities and Exchange Commission about the transaction charged in Count Two of the indictment.

In the fifth count, the indictment charged that Mr. Kendrick on February 10, 1978 swore falsely before the Securities and Exchange Commission about the transaction charged in Count Two of the indictment.

On October 23, the district court dismissed Count Four as multiplicitous.

On February 6, 1982 trial commenced before a jury. At the conclusion of the government's case defendant moved for acquittal on all counts. This motion was denied and defendant put on his defense. Defendant's renewed motion for acquittal was denied and the case was submitted to the jury. After two days of deliberation the jury announced they were hopelessly deadlocked on Count Two but had a guilty verdict on Counts One, Three and Five.

March 12, 1982 defendant again moved for acquittal and again this motion was

denied. Defendant was then sentenced and on March 26, 1982 judgment was entered with custody stayed pending appeal.

The defendant has spent his entire career in the stock brokerage business. After completing college, business school and the Marine Corps, Mr. Kendrick joined the stock brokerage firm of Eastman Dillon in New York City. He was very successful with this firm and ultimately became a partner in charge of the Western states. In 1970 he left Eastman Dillon to form his own firm Kendrick & Co.

Initially the firm was capitalized with Mr. Kendrick's own savings from Eastman Dillon. In 1972 the firm was incorporated and in 1973 the firm was recapitalized and several investors contributed capital to the firm. One such investor was the Congregation of the Passion, whose investment in part took the

form of a secured demand note, a New York Stock Exchange approved form of capitalizing brokerage firms.

Thereafter the financial well-being of Kendrick & Co. began to deteriorate. By the end of the fiscal year, March 31, 1975, the capital of Kendrick & Co., because of operating losses and the depressed state of the securities industry, was so impaired that the auditors (Ernst & Ernst) qualified their opinion in the annual report by noting that the continuation of the company as a going concern was dependent upon future profitable operations and/or obtaining additional capital.

Matters came to a head in August 1976. On August 18, 1976 Kendrick & Co. filed its Focus Report setting forth its financial condition for the period ending July 30, 1976 with the National

Association of Securities Dealers ("NASD"). As a result of this report Mr. Kendrick and the other officers of Kendrick & Co. were summoned to the NASD office in San Francisco at which time they were given a letter informing them that there was a net capital deficiency of approximately $63,000, an apparent violation of the net capital rules of the SEC (SEC Rule 15c3-1).

This meeting occurred on August 20, 1976, a Friday afternoon. As it happened Mr. Kendrick had plans to leave for a ten-day vacation.

In order to cure the net capital deficiency Mr. Kendrick, before he left town on August 20, 1976, wrote a check on his personal account to Kendrick & Co. for $150,000.

Over the weekend, in order to cover his $150,000 check to Kendrick & Co., Mr.

Kendrick told Mr. Hansen and Mr. Dougherty to issue a $150,000 check on Kendrick & Co. as an advance to Paul Kendrick personally. With the issuance of the $150,000 to Mr. Kendrick on August 23, 1976 the bank account of Kendrick & Co. would have been overdrawn.

The stage was set for the transaction which was to form the basis for Count One of the indictment.

One of the customers of Kendrick & Co. was Laurence Spitters. In order to effectuate the transactions of customers such as Mr. Spitters, Kendrick & Co. had entered into a New York Stock Exchange clearing agreement with another brokerage firm in San Francisco, Dean Witter & Co. Under this agreement Dean Witter handled the mechanics and accounting for the margin accounts of Kendrick & Co.'s customers.

Dean Witter looked to Kendrick & Co. for all instructions with regard to these accounts, including instructions for the advancement of funds. All of these instructions were guaranteed by Kendrick & Co.

On August 23, 1976 Mr. Spitters had a substantial number of securities in his margin account, and under the terms of the margin agreement with Mr. Spitters and the clearing broker these securities could be pledged to secure loans of the clearing broker. Kendrick & Co. employees instructed Dean Witter to deliver a $150,000 check on the Spitters margin account to Kendrick & Co. and this check was deposited in Kendrick & Co.'s bank account, thereby eliminating a possible overdraft. The transfer of these funds was later disclosed without explanation as a transfer of funds and margin loan on

the Dean Witter monthly statement mailed to Mr. Spitters.

In early September when Mr. Kendrick returned to San Francisco and prior to the time when Mr. Spitters had made any inquiry about the $150,000, Mr. Kendrick went to see Mr. Spitters and told him that he had purchased Treasury Notes for his account. Mr. Spitters testified that he did not want to establish a precedent for such discretionary trading, told Mr. Kendrick that he did not want this purchase, and asked Mr. Kendrick to reverse the transaction. Mr. Spitters' $150,000 was returned to Dean Witter.

Count Three of the indictment involved a similar occurrence. On the 13th of September Mr. Kendrick (utilizing his written authority) had Dean Witter issue a $27,000 check on the margin account of the Congregation of the Passion. These

funds were deposited in Kendrick & Co.'s bank account to cover checks used for the purchase of securities in Mr. Kendrick's account. Once again Dean Witter recorded the transaction as a margin loan. Later Kendrick & Co. told the Congregation's bookkeeper that the money was transferred to purchase securities. The money was later credited to the Congregation's capital account at Kendrick & Co.

REASONS WHY THE WRIT SHOULD BE GRANTED

1. The opinion below will result in a flood of run-of-the-mill state law offenses by fiduciaries becoming federal securities violations.

The two transactions are similar in that on both occasions Mr. Kendrick used the credit of a customer's margin account to obtain cash from Dean Witter.

As such it is the same as if Mr. Kendrick had withdrawn money from a customer's bank account to cover Kendrick & Co. checks and later told the customer it was to purchase securities. A customer's credit at a bank and a customer's credit with a clearing broker is a distinction without a difference. It is still nothing more than a breach of fiduciary duty.

The legislative history of Section 10(b) of the Securities Exchange Act of 1934 and the prior decisions of this Court make it clear that this statute's fundamental purpose is to implement a philosophy of full disclosure in securities transactions.

In the period since 1975, this Court has on numerous occasions exercised its certiorari jurisdiction in federal securities cases to limit the federal

remedy or its exercise, despite the expansive zeal of plaintiffs and prosecutors. This has led at least one commentator to note:

> "There can be little doubt about the intensity of the Court's concern over the expansion of securities liability and its determination to curb."

4 Bromberg, Securities Law Fraud, SEC Rule 10b-5, § 384.2.

In expressing this concern, this Court has noted that the Act should not be applicable to conduct where unnecessary to ensure fulfillment of Congress' purposes in adopting the Act and which has traditionally been relegated to state law. E.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977); Chiarella v. United States, 445 U.S. 222 (1980).

Recently in Marine Bank v. Weaver, ___ U.S. ___, 71 L.Ed.2d 409 (1982) this Court refused to extend the antifraud provisions of the federal securities laws to the issuance of a certificate of deposit to secure a bank loan guarantee and an agreement to share profits during the term of the guarantee with a holding that no security was involved.

A broker, and for that matter almost all fidiciaries, will have some relationship to securities in the performance of his business. The opinion below would apply the sanctions of Section 10(b) of the Securities Exchange Act of 1934 to all the actions of such fidiciaries no matter how remote the act complained of was to a fraudulent securities transaction.

2. The opinion below, by extending the scope of Section 10(b) of the Securities Exchange Act of 1934 to every act of financial mismanagement by a stock brokerage firm, is in conflict with prior decisions of this Court and the lower federal courts.

In its simplest form Mr. Kendrick was charged with kiting checks to cover a shortage of funds.

With the exception of the opinion below, this Court and the other circuit courts of appeal have refused to extend the antifraud provision of the securities laws beyond those situations where there was (1) fraudulent conduct and (2) the conduct was in connection with the purchase or sale of a security.

(a) There Was No Fraudulent Conduct Absent a Duty To Disclose.

Although the government charged Mr. Kendrick in Counts 1 and 3 with violating the anti-fraud provisions of Section 10(b) and Rule 10b-5, the government's proof at trial fell far short of the mark. Even if construed most favorably to the government, the government's case demonstrated, at best, questionable conduct by Mr. Kendrick. Although Mr. Kendrick's conduct might give rise to criticism of his judgment in dealing with the business stresses to which he was subject at that time, it does not provide a basis for convicting him of fraud under the federal securities laws.

The government's case against Mr. Kendrick was premised on the

theory that Mr. Kendrick omitted to inform his customers of certain actions that he was taking with respect to their margin accounts. Under this theory, the government was required to establish that, under the circumstances of this case, Mr. Kendrick's omissions constituted actionable fraud under Section 10(b) and Rule 10b-5. The government, however, failed to meet this burden.

When a defendant is charged with a fraudulent omission under Section 10(b) and Rule 10b-5, the government must establish that the defendant was under a duty to disclose certain information to the person who was allegedly defrauded. Chiarella v. United States, 445 U.S. 222 (1980). Failure by the

government to prove this critical element mandates a reversal. In Chiarella v. United States, 445 U.S. 222 (1980), for example, the defendant, a printer, learned from confidential documents which he was printing that a particular corporation was planning to secure control of a second corporation. The defendant immediately purchased stock in the target corporation without disclosing his knowledge of the takeover to the sellers of that stock. The government filed an action against the defendant claiming that defendant's silence was a "manipulative or deceptive device" under Rule 10b-5. Chiarella, 445 U.S. at 225. This Court held, however, that, because defendant had no duty to disclose to the seller of the

stock the information he obtained from the confidential documents, he could not be held criminally culpable under Section 10(b) or Rule 10b-5 for failing to disclose that information:

> "[N]ot every instance of financial unfairness constitutes fraudulent activity under § 10(b) [citations omitted]. . . . [T]he element required to make silence fraudulent -- a duty to disclose -- is absent in this case."

Chiarella, 445 U.S. at 232.

In the present case, the evidence introduced at trial reveals that, with respect to both Mr. Spitters' and the Congregation's accounts, Mr. Kendrick was not required to obtain the customers' prior approval or authorization before transferring funds in or out

of their accounts at Dean Witter. Mr. Kendrick was not, therefore, under a duty to disclose to his customers the specific actions he undertook with respect to these accounts. Absent such a duty to disclose, Mr. Kendrick's silence cannot sustain the government's Rule 10b-5 claim against him. */

A recent case in the Court of Appeals for the Seventh Circuit presents facts similar to the matter presently before the Court. In O'Brien v. Continental Illinois National Bank & Trust Co. of

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*/ To be sure, any improper use of customer funds by Mr. Kendrick might subject him to liability under state law for breach of fiduciary duty, conversion or embezzlement. However, the improper use of these funds alone, without an element of "deception," cannot sustain a Section 10(b) or Rule 10b-5 claim against him.

Chicago, 593 F.2d 54 (7th Cir. 1979), the trustees of several pension trusts entered into an agreement with defendant under which the funds of the trusts were turned over to defendant for investment. Defendant was given the authority to invest the funds in its sole discretion. The plaintiffs had no right to receive notice of or veto any investment decisions.

Plaintiffs subsequently sued defendant for fraud under Section 10(b) and Rule 10b-5 claiming that defendant, inter alia, failed to disclose to them adverse information about the "investment quality of the securities purchased" and a conflict of interests it had with the plaintiffs. O'Brien, 593 F.2d at 57. The court, however, rejected

plaintiffs' claims that defendant's failure to disclose was actionable under Section 10(b) and Rule 10b-5. The court reasoned that, because the defendant was "vested with sole discretionary power . . . to make purchases and sales of securities with the funds entrusted to it," defendant was not under any duty to give prior notice of its actions to the plaintiffs and could not, therefore, be held liable under Section 10(b) or Rule 10b-5 for not disclosing such information. O'Brien, 593 F.2d at 58.

The evidence introduced at the trial of Mr. Kendrick unequivocably shows that, with respect to Mr. Spitters' and the Congregation's accounts at Dean Witter, Mr. Kendrick, in his sole discretion, could

transfer funds in and out of their accounts at Dean Witter. Regardless of the purpose to which Mr. Kendrick may have put these funds, the evidence is clear that Mr. Kendrick had the sole discretion and authority to remove these funds from the accounts. As such, he was under no duty to his customers to provide them with prior notice of his actions. Under the rationale of the Chiarella and O'Brien cases, therefore, Mr. Kendrick's failure to notify the customers of his actions did not constitute a violation of Section 10(b) or Rule 10b-5.

The government seeks to disguise its failure to establish one of the essential elements of a Section 10(b) prosecution by propounding the argument that "these

provisions [Section 10(b) and Rule 10b-5] are broadly worded to make criminal 'any act' that operates as a fraud." Under the government's interpretation of these provisions, therefore, any fraudulent act in connection with the purchase or sale of a security is actionable under Section 10(b) and Rule 10b-5. Based on this interpretation of the law, the government concludes that Mr. Kendrick's actions, amounting to "highly sophisticated theft", must a priori be a type of fraud proscribed by Section 10(b) and Rule 10b-5.

The government's expansive interpretation of the coverage of Section 10(b) and Rule 10b-5, however, is wrong and contrary to this Court's more restricted interpretation of these provisions in Santa Fe

Industries, Inc. v. Green, 430 U.S. 462 (1977). In Santa Fe, Santa Fe Industries, which owned 95% of the stock of a lumber company, availed itself of Delaware's "short-term merger" statute in order to acquire 100% of the stock of the lumber company by offering $150 per share to the minority shareholders. The minority shareholders sued Santa Fe for fraud under Rule 10b-5 and claimed, among other things, that the offer of $150 per share was unfair and was intended solely to squeeze them out as minority shareholders. In rejecting this 10b-5 claim, this Court expressly rejected the notion, urged by the government herein, that all acts of unfairness or fraud in connection with the purchase or sale of securities are necessarily

proscribed by Section 10(b) and Rule 10b-5. Instead, this Court ruled that Section 10(b) and Rule 10b-5 apply solely to those circumstances where the defendant engaged in acts of misrepresentation or nondisclosure which were intended to deceive the purchaser or seller of securities:

> "The finding of the District Court . . . was that there was no 'omission' or 'misstatement' in the information statement supplied by Santa Fe . . . ."

Santa Fe, 430 U.S. at 474.

This Court went on to state that,

> "[T]he cases [cited by minority shareholders] do not support the proposition . . . that a breach of fiduciary duty by majority shareholders, without any deception, misrepresentation, or nondisclosure,

> violates the statute and the Rule."

Santa Fe, 430 U.S. at 476 (emphasis added).

Several cases subsequent to Santa Fe have reaffirmed that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." Chiarella v. United States, 445 U.S. 222, 232 (1980); see also, Panter v. Marshall Field & Co., 646 F.2d 271, 287-88 (7th Cir.), cert. denied, 454 U.S. 1092 (1981). In Panter, for example, shareholders brought a derivative action against the corporation and its directors claiming, inter alia, that the directors violated Section 10(b) and Rule 10b-5 when they successfully fended off a takeover attempt by another corporation and

thereby deprived plaintiffs of an opportunity to dispose of their shares at a premium. Plaintiffs claimed that the directors acted solely to perpetuate their control over the corporation. Panter, 646 F.2d at 287. The court, however, rejected plaintiffs' claims, noting that Section 10(b) and Rule 10b-5 require an element of deception:

> "As the Supreme Court noted in Santa Fe Industries, Inc. v. Green. [citations omitted], the rule [Rule 10b-5] is a manifestation of the 'philosophy of full disclosure', embodied in the Securities Exchange Act of 1934; it therefore requires proof of the element of deception. . . ."

Panter, 646 F.2d at 287.

The government claims, in essence, that Mr. Kendrick violated Section 10(b) and Rule 10b-5 by using for his own purposes, without

the knowledge or prior approval of his customers, various funds entrusted to his care. Indeed, the government refers to Mr. Kendrick's actions as nothing more than highly sophisticated theft -- as "stealing" or "misappropriation" of funds. Santa Fe and its progeny clearly demonstrate, however, that such conduct, no matter how reprehensible, cannot sustain a claim of fraud under Section 10(b) or Rule 10b-5 unless the government can establish that Mr. Kendrick had a duty of disclosure to his customers before effecting any transactions in their accounts. Absent this additional showing, the government's claims against Mr. Kendrick under the federal securities laws must fail.

(b) The Alleged Violations of Section 10(b) Did Not Occur in Connection With the Purchase or Sale of a Security.

The convictions of defendant on Counts One and Three of the indictment are similar in that in both cases the defendant caused a check to be drawn on a customer's margin account pursuant to a written clearing agreement at another brokerage firm (Dean Witter) and deposited in the general bank accounts of Kendrick & Co. The effect of these transfers was to increase the debit balance of the customers in their Kendrick & Co. accounts at Dean Witter. In other words, the defendant used the pledged securities of their customer in the clearing broker's margin account to borrow money for Kendrick & Co.

Accordingly, the legal issue presents itself as follows: when a broker uses a customer's pledged securities in a margin account to secure a loan from another clearing broker does this act occur in connection with the purchase or sale of a security?

It is axiomatic that in order for conduct to come within the purview of Section 10(b) the conduct must occur in connection with the purchase or sale of a security. E.g., Superintendent of Ins. of the State of N.Y. v. Banker's Life & Cas. Co., 404 U.S. 6 (1971); In re Penn Central Securities Litigation, 494 F.2d 528 (3rd Cir. 1974).

It is noteworthy that in this case the government to date has been unable to cite one case (let alone a

criminal case) where a court found a Section 10(b) violation for the act complained of -- the use of a customer's pledged securities to borrow money from a margin account. In the district court the government relied heavily if not exclusively on this Court's decision in Rubin v. United States, 449 U.S. 424 (1981). However, that case presented a far different factual situation than the facts of the present case. In Rubin the defendant was convicted of pledging worthless stock to a financial institution as collateral for a loan. In connection with the loan transaction an affirmative fraudulent representation that the stock had value was made to the bank. This Court held that such a pledge was a disposition of an interest in

a security for value and therefore an "offer" or "sale" within the meaning of Section 17(a) of the Securities Act of 1933.

In contrast, there was no disposition of any securities in the present case. The customers' securities were pledged under the written clearing agreement with Dean Witter prior to the transfer of any funds from Dean Witter to Kendrick & Co. and the securities remained pledged after the transfer. The securities did not undergo any change as to the ownership rights of the parties. Even if an employee of Dean Witter had written a check to himself on the account of the customers and pocketed the money, it might constitute breach of trust but

not a fraud in connection with the purchase or sale of a security.

As has this Court, the lower courts have frequently held that there are limits to the scope of Section 10(b). For example in In re Penn Central Securities Litigation, 494 F.2d 528 (3rd Cir. 1974) the Court of Appeals for the Third Circuit distinguished between the typical merger situation covered by Section 10(b) and a reorganization where persons holding stock in a railroad company exchanged it for stock of a holding company. The court found the latter reorganization was merely an internal corporate management act.

Even in Superintendent of Ins. of the State of N.Y. v. Banker's Life & Cas. Co., 404 U.S. 6, 12

(1971), this Court noted that "Congress by Sec. 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement".

In the present case the alleged fraud had no relation to a securities transaction. Indeed the government has made no effort to point to any specific security which should have been identified in the indictment, the evidence, and the court's instructions to the jury. The district court refused these instructions. That the government must prove a specific security transaction is illustrated by this Court's recent decision in Marine Bank v. Weaver, ___ U.S. ___, 71 L.Ed.2d 409 (1982) where the Court differentiated between a securities

transaction on the one hand and the purchase and pledge of a certificate of deposit and an agreement to secure a loan on the other.

All margin accounts of Kendrick & Co. were managed by Dean Witter pursuant to the clearing agreement whereby Kendrick & Co. designated Dean Witter to hold Kendrick & Co. customer securities. Dean Witter was paid for this service, and Kendrick & Co. was continually borrowing money from Dean Witter as well as instructing Dean Witter to execute securities transactions, pay out or receive money, and deliver or receive securities. The transfer of funds under this clearing agreement cannot be said to be in connection with the purchase or sale of securities.

(c) There Was No Effort To Prove That the Alleged Fraudulent Acts Occurred Contemporaneously With the Purchase or Sale of Securities.

Other lower courts have held that any fraudulent act violating Section 10(b) must occur prior to or contemporaneously with the purchase of securities. In Rich v. Touche, Ross & Co., 415 F.Supp. 95, 100 (S.D.N.Y. 1976), the court held that to satisfy the "in connection with" requirement, the alleged fraud must be "'intrinsic to the securities transaction itself.' [citation omitted]". Similarly, in Troyer v. Karcagi, 476 F.Supp. 1142, 1148 (S.D.N.Y. 1979), a lower federal court said:

> "To satisfy the 'in connection with' requirement . . . more than a purchase is required . . . there

> must be a causal connection between defendant's misstatements or omissions and the . . . purchase . . . . There can be no such causal connection where the misstatement or omission occurred after the purchase."

In the present case the execution of any securities transactions which resulted in securities being pledged in the margin accounts at Dean Witter took place long before the alleged misappropriations occurred. It follows logically that the alleged fraudulent act was not "intrinsic" to the securities transactions nor "causally connected" to these transactions because it was not contemporaneous with the transactions.

The fact that Mr. Kendrick may have later falsely stated that he had withdrawn the funds to purchase

securities is irrelevant since this is neither causally related to the transaction nor is it contemporaneous with the transaction.

The form of the transfer in the present case is analogous to the trust relationship discussed in O'Brien v. Continental Illinois National Bank & Trust Co. of Chicago, 593 F.2d 54 (7th Cir. 1979). In O'Brien the alleged fraud occurred when defendant, a trustee bank, failed to disclose inside information to the trust beneficiaries prior to making investments which, according to the trust agreement, were within the trustee's discretion. The O'Brien court held that no actionable fraud had occurred within the meaning of the Securities Exchange Act because the

alleged fraud did not occur in connection with a marketing transaction, but rather occurred in connection with a trust relationship. The court refused to extend the reach of Section 10(b), stating that this law only protects marketing transactions and does not regulate trust relationships.

The transfers involved in Counts One and Three are also analogous to the bailment relationship discussed in Rich v. Touche, Ross & Co., 415 F.Supp. 95 (S.D.N.Y. 1976) where the plaintiff (bailor) alleged that the defendant accounting firm had fraudulently misstated the financial condition of the brokerage firm (bailee) with which the plaintiff had entrusted certain securities. The court held that even if

the misstatement caused plaintiff to continue a bailment which it might otherwise have terminated, the misstatement was not fraudulent within the meaning of Section 10(b) because it was not a misstatement in connection with the purchase or sale of securities. The court stated, "any misstatements . . . could not have been material to the decision to sell . . . shares at an earlier date" (emphasis supplied), and therefore were not in connection with a purchase or sale of securities. Rich, 415 F.Supp. at 101.

The situation in this case is nearly identical to the situation in the O'Brien and Rich cases. Any omission or misrepresentation Mr. Kendrick is alleged to have made about the two transactions for which

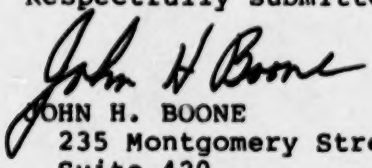
he was charged could not have been material to the earlier decisions of Father Parsons or Mr. Spitters to pledge stock in the Kendrick & Co. margin accounts at Dean Witter. The alleged fraud did not occur in connection with a marketing transaction, but rather occurred in connection with a fiduciary relationship. Accordingly there was a failure to prove a purchase or sale of a security which occurred contemporaneously with the allegedly fraudulent acts.

CONCLUSION

In order to protect the integrity of the antifraud provisions of the federal securities laws and to resolve the conflict between the opinion below and the law in the other circuit courts

of appeal, the writ should be granted as asked.

Respectfully submitted,



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(Appendices Follow)

Appendix A

United States Court of Appeals
For the Ninth Circuit

No. 82-1190
USDC No. CR-81-0312-1-WWS

UNITED STATES OF AMERICA,
Plaintiff-Appellee,

vs.

PAUL F. KENDRICK,
Defendant-Appellant.

O P I N I O N

On Appeal from the United States District Court for the Northern District of California
Hon. William W. Schwarzer, Presiding

Argued and Submitted: October 12, 1982
[Filed November 22, 1982]

Before: MERRILL and BOOCHEVER, Circuit Judges, and SMITH,* District Judge.

* Honorable Russell E. Smith, Senior District Judge, United States District Court for the District of Montana, sitting by designation.

MERRILL, Circuit Judge:

Appellant Paul F. Kendrick, a stock-broker, appeals from his conviction following jury trial of two counts of violating federal securities laws and one count of perjury. On appeal appellant makes many assignments of error. The principal issue presented is whether the actions taken by him in connection with margin accounts of two of his customers were taken "in connection with the purchase or sale" of securities in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)[1] and Securities and Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. § 240.10b-5.[2]

I.

Appellant in 1970 formed his own firm, Kendrick & Co., with its office in San Francisco, California. Appellant was

the chief executive officer and principal shareholder. In 1971, Kendrick & Co. was licensed by the SEC. For two of its customers, Laurence Spitters and the Congregation of the Passion (a Roman Catholic religious order), Kendrick & Co. established margin accounts with Dean Witter & Co. in San Francisco, each of which accounts was secured by pledged securities owned by the customer and placed in the hands of Dean Witter. Dean Witter looked to appellant for instructions in the advancing of funds against the accounts.

By 1976 Kendrick & Co. was experiencing financial difficulties and its condition came to the attention of the National Association of Securities Dealers ("NASD"), a voluntary association of stockbrokers which acts as a self-regulatory body and attempts to discover

and forewarn members of violations of SEC rules. On October 20, 1976, NASD informed appellant that Kendrick & Co. had a deficiency in net capital in violation of SEC rules, which deficiency amounted to $63,000.00. To meet this problem, appellant engaged in the actions with which we are involved. We need not describe them in detail. They are quite complex.

In brief, appellant wrote a check on his personal bank account in the sum of $150,000.00, deposited it in the bank account of Kendrick & Co. and had an associate notify the NASD that Kendrick & Co. had taken care of the net capital deficiency. Appellant's bank account did not have funds to cover such a draft. In a series of steps, he made unauthorized drafts on the Dean Witter margin account of Spitters and deposited the sum so

secured in his account, falsely reporting to Spitters that the withdrawals had been for the purpose of acquiring securities for him. Kendrick & Co. books did not properly reflect the transactions. Dean Witter, in accordance with representations of appellant, recorded the transactions as a loan to Spitters, secured by the pledged securities.

Appellant through a series of similar transactions converted to his personal use $27,000 from the Dean Witter account of the Congregation of the Passion, in order to cover checks used for the purchase of securities in appellant's personal account. Once again Dean Witter recorded the transaction as a loan. Appellant falsely told the Congregation's bookkeeper that the money withdrawn from the Congregation's account had been used to purchase securities.

II.

1. The question presented is whether these acts constituted and thus were in connection with the purchase and sale of securities as those terms are used in § 10(b) and Rule 10b-5. We hold that they did.

Rubin v. United States, 449 U.S. 424 (1981), involved § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), which makes it unlawful to engage in fraudulent conduct "in the offer or sale of any securities." The question there presented was whether a pledge of stock as collateral for a loan constituted an "offer or sale" under § 17(a). Petitioner, the pledgor, argued that the securities had been deposited with the pledgee "only as security for a loan, not as a transfer or sale." He argued that "the implied power to dispose of the

stocks could ripen into title and thereby constitute a 'sale' only by effecting foreclosure * * *". 447 U.S. at 429.

The Supreme Court rejected this contention. Section 2(3) of the Act defined "sale" to include "every contract of sale or disposition of a security or interest in a security for value." The Court held that "[o]btaining a loan secured by a pledge of shares of stock unmistakably involves a 'disposition of [an] interest in a security, for value.' Although pledges transfer less than absolute title, the interest thus transferred nonetheless is an 'interest in a security'." Id.

The definition of "sale" in the 1934 Act, with which we are concerned, is set forth in Section 3(14) of the Act, 15 U.S.C. Section 78c(14). It reads:

"(14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

In Mallis v. Federal Deposit Insurance Corporation, 568 F.2d 824, 829-30 (2d Cir. 1976), cert. dismissed, 435 U.S. 381 (1978), the court gave the same meaning to "sale" in the 1934 Act that it had earlier given to the word as used in the 1933 Act, and held that a pledge of securities constituted a sale under Rule 10b-5. We agree with that holding. If a pledge of securities is a disposition of an interest in those securities, it follows that it also is a contract to dispose of that which is pledged. For purposes of § 10(b) of the 1934 Act and Rule 10b-5, then, Spitters and the Congregation were the defrauded "sellers" of securities and Dean Witter the "purchaser."

The fact that no new pledge was made in connection with the loans does not affect the outcome. It was not the fact that the securities were in the possession of Dean Witter that gave Dean Witter an interest in them. It was the fact that they were subjected as collateral to the new loans and that Dean Witter thereby acquired an interest in them in an amount equal to the amounts loaned. There was testimony by Dean Witter personnel that in issuing the checks drawn on the margin accounts Dean Witter engaged in an investment decision as to whether the stocks it already held were sufficient to cover its loss should the borrower default. Dean Witter gained an additional interest in the collateral as a result of the loans. When that interest was created, the "sale" occurred.

2. Appellant contends that his actions were not fraudulent. We find no merit whatsoever in this contention. [3/] The court properly instructed the jury that it had to find that "defendant used a manipulative device which operated or would operate as a fraud or deceit on someone." There was ample evidence from which the jury could find fraud. Appellant failed to disclose to his customers (and also to Dean Witter) that he was acting beyond his authority in using customer funds for his own use or the use of Kendrick & Co. Further, he falsely stated to each customer that the funds in question had been used to acquire securities for the accounts of the customers.

3. Appellant contends that if there was fraud it was disassociated in point of time from the "sale" and thus was not "in connection with" the sale as

required to support a conviction under § 10(b) and Rule 10b-5. We find no merit in this. While some preliminary acts occurred prior to the loan from Dean Witter, the misrepresentations and omissions that caused the loans to be made were clearly fraudulent and in connection with the loans. At the time Kendrick caused Dean Witter to issue the checks on the margin accounts of Spitters and the Congregation, he was engaged in fraud.

4. Appellant assigns as error the failure of the court to give a requested jury instruction to the effect that he may have had implied authority from Spitters to secure the draft from his account with Dean Witter. [4/] This was not in error. There was nothing from which the jury could have concluded that appellant had implied authority to draw on Spitter's [sic] non-discretionary

account for his own benefit. In any event, the jury instructions required that the appellant be found to have acted "willfully" and required the jury to consider "such factors as the nature of the relationship between the defendant and the people named in each count, and whether those people knew of, understood or authorized the defendant's particular actions." The instructions covered this aspect of the appellant's case adequately and that is all that is required. United States v. Kenny 645 F.2d 1323, 1337 (9th Cir.), cert. denied, 452 U.S. 920, 454 U.S. 828 (1981).

5. Appellant contends that there was a variance between the charge of the indictment (that he knowingly converted to his own use money belonging to the Congregation) and the proof (which was that the conversion, if there was one,

was to the use of Kendrick & Co.) We find no merit here. The jury could have concluded that appellant used the $27,000.00 to aid his purchase of stock for his own account, because there was evidence that on the same day $27,000.00 was transferred from the Kendrick & Co. account into appellant's personal bank account. In any event, the withdrawal was to appellant's benefit, to keep Kendrick & Co. afloat. Even if there was some slight variance, no substantial right of appellant was prejudiced. See United States v. Phillips, 577 F.2d 495, 502 (9th Cir.), cert. denied, 439 U.S. 831 (1978).

6. Appellant was indicted for and found guilty of perjury in violation of 18 U.S.C. § 1621 in giving false testimony before the SEC. He had testified there that he had asked Father Parsons,

an official of the Congregation, for permission to secure a $104,000.00 loan from the Congregation's Dean Witter margin account and that the official had given his approval. [5/] This Father Parsons had denied in testimony in the course of trial below. Appellant challenges the sufficiency of the evidence of perjury in three respects. The standard of review is whether, reviewing the evidence in the light most favorable to the government, any rational finder of fact could have found the essential elements of the crime beyond a reasonable doubt. Jackson v. Virginia, 443 U.S. 307, 318-19 (1979).

First, he contends that the statements before the SEC, when taken in context, are equivocal. [6/] We do not find them so and a rational jury could have found them unequivocal. If the

apparent meaning was incorrect, the appellant had an opportunity to place the testimony in proper context had he so chosen.

Second, appellant contends that there was no proof that the false statement was willfully made. The jury was properly charged on appellant's theory and rejected it. A rational inference of willfulness from the proven facts was available.

Third, appellant contends that the government failed to meet the requirement that it produce testimony of two independent witnesses or one witness plus corroborating evidence. Weiler v. United States, 323 U.S. 606 (1945). There was ample corroboration. An accountant testified that the loan explanation was an after-the-fact concoction. A handwriting expert testified that Father

Parsons's signature on the confirmation letter was not genuine. An Internal Revenue Agent testified that appellant had explained to him that the $150,000.00 deposit in his personal account was a loan from the Congregation. The two-witness rule was more than satisfied.

7. Finally, appellant argues that his conviction should be reversed because of undue preindictment delay, citing United States v. Marion, 404 U.S. 307 (1971). Proof of prejudice is a necessary element of a claim of preindictment delay. See United States v. Lovasco, 431 U.S. 783, 790 (1977). Appellant has failed to make any showing that he was prejudiced by delay other than speculation as to what one witness may have forgotten or what certain allegedly missing documents may have revealed. This does not suffice. United States v.

Mills, 641 F.2d 785, 788-89 (9th Cir.), cert. denied, 454 U.S. 902 (1981); United States v. Mays, 549 F.2d 670, 677 (9th Cir. 1977).

JUDGMENT AFFIRMED.

FOOTNOTES

1/ (p.[A-2]) Section 10 reads in relevant part as follows:

> It shall be unlawful for any person directly or indirectly, by the use of any means of instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--
>
> * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2/ (p.[A-2]) Rule 10b-5 reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

3/ (p.[A-10]) Appellant contends for the first time in his Reply Brief that the jury instruction on fraud was erroneous because it did not require a finding that appellant had a duty to disclose. We do not consider this contention. "[T]he general rule is that appellants cannot raise a new issue for the first time in their Reply Brief." Thompson v. CIR, 631 F.2d 642, 649 (9th Cir. 1980), cert. denied, 452 U.S. 961 (1981).

4/ (p.[A-11]) At trial, Spitters admitted that at a May 1978 SEC proceeding he had "testified that an implied authorization might have been interpreted from the course of transactions between myself and Kendrick and Co."

5/ (p.[A-14]) The $104,000.00 loan about which appellant testified falsely formed the basis of Count Two of the indictment, which alleged that appellant misappropriated to the use of Kendrick & Co. those funds from the Congregation.

The jury was unable to reach a verdict as to this Count but this alone does not void the perjury conviction.

6/ (p.[A-14]) Appellant had testified:

> Q. Did you ask Father Parsons for permission to borrow the money?
>
> A. Within that meeting I did.
>
> Q. What did Father Parsons say?
>
> A. He gave his approval for the loan.
>
> Q. Are you sure?
>
> A. Yes, sir.

Appendix B

UNITED STATES DISTRICT COURT for the
Northern District of California

UNITED STATES OF AMERICA vs.

PAUL F. KENDRICK

Docket No.: CR-81-0312 WWS

JUDGMENT AND PROBATION/COMMITMENT ORDER

In the presence of the attorney for the government the defendant appeared in person on March 26, 1982 with counsel John H. Boone and Geoffrey P. Knudsen.

PLEA

Not Guilty.

FINDING AND JUDGMENT

There being a verdict of guilty on Counts One, Three and Five, Defendant has been convicted as charged of the offenses of Title 15, U.S.C., Sections 78j(b) and 78ff(a), 17 C.F.R. Sections 240.10b-5;

Title 18, U.S.C., Section 1621 -- Fraudulent Acts In Connection With Purchase And Sale Of Securities; Perjury.

SENTENCE OR PROBATION ORDER

The court asked whether defendant had anything to say why judgment should not be pronounced. Because no sufficient cause to the contrary was shown, or appeared to the court, the court adjudged the defendant guilty as charged and convicted and ordered that: The defendant is hereby committed to the custody of the Attorney General or his authorized representative for imprisonment for a period of five (5) years. The execution of sentence is suspended as to all but the first six (6) months which is to be served in a jail-type institution and followed by a term of five (5) years probation upon release. This is the

sentence for Counts One, Three and Five which is to run concurrently.

IT IS FURTHER ORDERED that the defendant be fined the sum of $10,000 for Count One and $10,000 for Count Three which is to be paid in a lump sum or in installments arranged through the Probation Office. The execution of sentence of this fine is suspended for 120 days pending review of the appeal.

IT IS FURTHER ORDERED that a stay of execution of the sentence of imprisonment be granted pending disposition of the appeal.

IT IS FURTHER ORDERED that Counts Two and Four of the superseding indictment be dismissed.

ADDITIONAL CONDITIONS OF PROBATION

In addition to the special conditions of probation imposed above, it is hereby ordered that the general

conditions of probation set out on the reverse side of this judgment be imposed. The Court may change the conditions of probation, reduce or extend the period of probation, and at any time during the probation period or within a maximum probation period of five years permitted by law, may issue a warrant and revoke probation for a violation occurring during the probation period.

COMMITMENT RECOMMENDATION

The court orders commitment to the custody of the Attorney General and recommends Lompoc Camp.

It is ordered that the Clerk deliver a certified copy of this judgment and commitment to the U.S. Marshal or other qualified officer.

Signed by:

U.S. District Judge
WILLIAM W. SCHWARZER

Date: March 29, 1982

AFFIDAVIT OF SERVICE BY MAIL

State of California
City and County of San Francisco -- ss.

Josie Strupaitis, being first duly sworn, says:

That affiant is a citizen of the United States, over 18 years of age, and not a party to the within cause; that affiant's business address is 235 Montgomery Street, Suite 420, San Francisco, California 94104; that affiant served the required number of copies of the attached Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit on each of the following, by placing same in an envelope addressed (respectively) as follows:

Solicitor General
Department of Justice
Washington, D.C. 20530

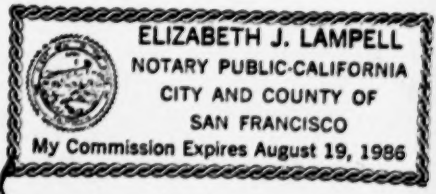
Ben Burch
United States Attorney
Federal Building, Room 16201
450 Golden Gate Avenue
San Francisco, CA 94102

that each of said envelopes was then, on January 27, 1983, saled and deposited in the United States mail at San Francisco,

California, with the postage thereon fully prepaid; and that there is delivery service by United States mail at each place so addressed, or that there is regular communication by mail between the place of mailing and each place so addressed.

Jesus Estupinian

Subscribed and sworn to before me this 27th day of January, 1983



Elizabeth J. Lampell
Notary Public in and for the City and County of San Francisco, State of California

No. 82-1263

Office - Supreme Court, U.S.
FILED
APR 14 1983
ALEXANDER STEVAS,
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1982

PAUL F. KENDRICK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the scheme of a securities broker to pledge (without a customer's knowledge or consent) an interest in that customer's securities and to misappropriate the proceeds of that pledge, is prohibited by Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5(c), 17 C.F.R. 240.10b-5(c).

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In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-1263

PAUL F. KENDRICK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the court of appeals (Pet. App. A-1 to A-20) is reported at 692 F.2d 1262.

JURISDICTION

The judgment of the court of appeals was entered on November 22, 1982. A petition for rehearing was denied on December 20, 1982. The petition for a writ of certiorari was filed on January 28, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the Northern District of California, petitioner was convicted on two counts of securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5(c), 17 C.F.R. 240.10b-5(c), and one count of perjury in violation of 18 U.S.C. 1621.[1]

[1]The jury could not reach a verdict on a third securities count charging an additional violation of Section 10(b) and Rule 10b-5(c).

Petitioner received concurrent five-year sentences on each of the three counts, with all but six months suspended, and a $10,000 fine for each of the securities fraud counts (Pet. App. A-22 to A-23). The court of appeals affirmed (Pet. App. A-1 to A-20).

1. The evidence at trial showed as follows. In 1976, petitioner was president of Kendrick & Co., a securities brokerage firm located in San Francisco, California. On August 20, 1976, the National Association of Securities Dealers ("NASD") warned petitioner that Kendrick & Co. was operating in violation of the "net capital rule." [2] That rule is the principal regulatory tool with which the Securities and Exchange Commission protects customers against the risks of financial insolvency of brokerage firms holding their cash or securities (Tr. 3-12).

In order to conceal his firm's net capital deficiency, on August 23, 1976, petitioner deposited a personal check for $150,000 in the bank account of Kendrick & Co. He then informed the NASD that the firm's net capital problem had been solved (Tr. 10-13, 55-57). At the time, petitioner had less than $5,000 in his personal bank account (Tr. 858). The same day, petitioner removed $150,000 from a margin account[3] that Kendrick & Co. maintained for one of its

---

[2]Section 15(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(c)(3), and Rule 15c3-1, 17 C.F.R. 240.15c3-1, require that brokers maintain a minimum amount of liquid assets, known as "net capital," to ensure payment of their customers' claims for cash or securities. See *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 570 & n.10 (1979).

[3]A margin account permits a customer to purchase securities on credit extended by his broker. When a customer purchases securities on margin, the customer must initially provide at least 50% of the purchase price of the securities. The broker takes a security interest in the securities purchased in an amount sufficient to secure the loan, and usually retains possession of the securities (Tr. 178-179). The broker may thereafter lend additional monies to his margin account customer, accepting as collateral a pledge of a greater security interest in stock already in the customer's margin account (Tr. 180-181).

customers, Lawrence Spitters, at another brokerage firm, Dean Witter (Tr. 134-140, 155-156). Spitters was away on vacation at the time, and never approved the transaction (Tr. 134-137, 142).[4] Dean Witter recorded the transaction as a $150,000 loan to Spitters, entrusted petitioner with a check for $150,000 payable to Spitters, and took as collateral for the loan a security interest in common stock which Spitters maintained in the margin account (Tr. 142, 155-156, 186). Dean Witter's $150,000 check was deposited in Kendrick & Co.'s bank account, with Spitters' endorsement forged on it (Tr. 142-143). The $150,000 was then transferred to Kendrick's personal bank account to cover the original check to Kendrick & Co. (which had been used to cure the firm's net capital problem) (Tr. 71-72). Later, petitioner contacted Spitters and falsely represented that he had used the $150,000 to purchase government securities for Spitters (Tr. 136-137, 182-183).[5] This transaction was the basis for petitioner's conviction on the first securities fraud count.

---

[4]Spitters' account at Dean Witter was nondiscretionary; Kendrick & Co. employees were required to get Spitters' approval prior to effecting any transactions in the account (Tr. 134, 188). A Dean Witter representative testified that the firm permits brokers to exercise discretion over margin accounts maintained with it *only* upon filing with Dean Witter an express written authorization by the brokers' customers (Tr. 187). Dean Witter had no written authorization from Spitters permitting Kendrick & Co. to exercise discretion over his margin account (Tr. 188). Petitioner requested the district court to instruct the jury that he had "implied authority" to effect transactions in Spitters' account without Spitters' prior approval. The district court refused, however, to give such an instruction, and the court of appeals affirmed that ruling (Pet. App. A-11 to A-12).

[5]Spitters ordered the unauthorized transactions in his account to be reversed, notwithstanding petitioner's representation that a profit could be made by simply ratifying the purported purchase of government securities (Tr. 136, 149).

In order to obtain funds to transfer $150,000 back to Spitters' Dean Witter account, petitioner secretly removed over $100,000 from a bank account which he maintained for another customer, the Congregation

In September 1976, petitioner bought securities for his own account at Kendrick & Co., but had insufficient funds to cover the personal checks he wrote to pay for the purchases (Tr. 98-105). Petitioner, therefore, removed $27,000 from a margin account maintained at Dean Witter for a second client, the Congregation of the Passion, a Roman Catholic religious order (Tr. 202-203, 404). As in the case of the Spitters' transaction, Dean Witter recorded a $27,000 loan to the Congregation, entrusted petitioner with a $27,000 check payable to the Congregation, and took as collateral for the loan a security interest in common stock held in the margin account (Tr. 201-203). The Congregation's endorsement on the check was forged, the check was deposited in Kendrick & Co.'s bank account, and the $27,000 was ultimately transferred to petitioner's personal bank account to cover the checks he had written (Tr. 222-223). Representatives of the Congregation had no knowledge of the transaction (Tr. 404, 406-407).[6] In order to conceal his misappropriation, petitioner subsequently represented to the Congregation that the $27,000 had been borrowed from its margin account to purchase securities for the Congregation's own account (*ibid.*). This transaction was the basis for petitioner's conviction on a second securities fraud count.

---

of the Passion, a religious order. During an investigation by the Commission in 1978, petitioner falsely testified that he had asked for permission to borrow this money from the Congregation (Tr. 498-499). Petitioner's false testimony was the basis of his conviction for perjury in this case (see page 1, *supra*).

[6]Unlike Spitters' margin account, the Congregation's account was discretionary. Petitioner's own expert witness conceded, however, that petitioner had no authority to engage in transactions in the account to secure money *for his own use* (Tr. 579-580).

2. The court of appeals (Pet. App. A-1 to A-20) found that there was "no merit whatsoever" to petitioner's contention that his conduct was not a fraudulent practice prohibited by Section 10(b) of the Securities Exchange Act of 1934 and by SEC Rule 10b-5(c) (Pet. App. A-10). The court noted that petitioner not only failed to disclose to his customers that he was using their accounts for his own purposes, but also falsely represented to each customer that he had used the money properly to acquire securities for them (*id.* at A-10). The court also rejected the contention that there was no "sale" of a security within the meaning of the statute and regulation (*id.* at A-6 to A-9). The court found that a "sale," within the meaning of Section 3(14) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(14), occurred when Dean Witter acquired an additional interest in the customers' securities as collateral for $177,000 in loans (Pet. App. A-9); Dean Witter was the "purchaser" of an interest in the securities, and Spitters and the Congregation were the "sellers" whom petitioner defrauded (*id.* at A-8). Finally, the court rejected petitioner's contention that his fraudulent conduct was not "in connection with" the purchase or sale of securities (*id.* at A-10 to A-11). As the court explained, petitioner "was engaged in fraud" when he pledged an interest in his customers' securities (*id.* at A-11).

ARGUMENT

1. Petitioner argues (Pet. 17-31) that his activities were not fraudulent because he had no duty to disclose them to his customers.[7] Petitioner's argument is, however, based on a mischaracterization of the evidence against him. Petitioner's convictions do not rest on mere silence. Petitioner was

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[7]The court of appeals found that this argument, which was presented for the first time in petitioner's reply brief in the court of appeals, had not been properly raised before it (Pet. App. A-10 n.3). Accordingly, this argument has not been preserved for this Court's review. See *United States* v. *Lovasco*, 431 U.S. 783, 788 n.7 (1977).

convicted for engaging in schemes involving a number of acts of concealment, including affirmative misrepresentations to his customers.[8] The schemes were calculated to conceal from his customers, the NASD, Dean Witter and others, the fraudulent pledges of his customers' stock. Active concealment of the truth is itself fraudulent, even absent an independent duty to speak. See *United States* v. *Bohonus*, 628 F.2d 1167, 1172 (9th Cir.), cert. denied, 447 U.S. 928 (1980); *United States* v. *Bush*, 522 F.2d 641, 651 (7th Cir. 1975), cert. denied, 424 U.S. 977 (1976); 3 L. Loss, *Securities Regulation* 1434-1435 (1961).[9]

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[8]Petitioner's argument (Pet. 15, 27, 29) that the court of appeals' decision in this case conflicts with *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977), and *Panter* v. *Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981), is without foundation. In *Santa Fe* the defendant had "furnished * * * all relevant information" to the plaintiffs, and therefore had not engaged in any form of deception. 430 U.S. at 474-475. Similarly in *Panter* the defendants had disclosed all material facts, and consequently there was not "sufficient evidence to support a * * * finding of the element of deception required by Section 10(b) and Rule 10b-5." 646 F.2d at 293. By contrast, as the court of appeals found (Pet. App. A-10), the evidence in this case amply demonstrated that petitioner did not make full disclosure of all material facts.

[9]Even assuming that petitioner's conduct could be described as mere nondisclosure, it would be fraudulent on the facts of this case. As a broker, petitioner was the agent and fiduciary of his customers. See, *e.g.*, *Henricksen* v. *Henricksen*, 640 F.2d 880, 886 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); *Rolf* v. *Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 45 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); *McMann* v. *SEC*, 87 F.2d 377, 378 (2d Cir.), cert. denied, 301 U.S. 684 (1937). His silence therefore operated as a fraud on the customers. Indeed, it is the existence of this fiduciary duty that readily distinguishes this case from *Chiarella* v. *United States*, 445 U.S. 222, 232 (1980), relied upon by petitioner (Pet. 19-21).

Contrary to petitioner's contention (Pet. 22-26), there is no inconsistency between the decision below and that of the Seventh Circuit in *O'Brien* v. *Continental Illinois National Bank & Trust Co.*, 593 F.2d 54 (1979), with regard to fraud in a fiduciary relationship. In *O'Brien*, the court stressed that the defendant, a bank trustee, had "sole discretion" to make the securities transactions in dispute. 593 F.2d at 57. Accordingly, the court held that the plaintiffs could not recover damages under

2. Petitioner next argues (Pet. 32-38) that there was no "sale" of securities involved in his scheme to save his brokerage firm. Petitioner does not, however, discuss the statutory definition of "sale" or cite any decision indicating that the pledge of a security to obtain a loan is not a sale of a security. As the court of appeals held (Pet. App. A-6), petitioner caused securities to be "sold" within the meaning of Section 3(14) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(14), when he pledged stock to obtain loans from Dean Witter. As this Court recently observed, "a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws." *Marine Bank* v. *Weaver*, 455 U.S. 551, 554 n.2 (1982). See also *Rubin* v. *United States*, 449 U.S. 424 (1981). It was no defense that the securities were already subject to a security interest owned by Dean Witter. As the court of appeals found (Pet. App. A-9), Dean Witter gained an "additional" $177,000 interest in the securities when it advanced that sum of money using the securities as collateral.

Nor is there any merit to petitioner's related contention that even assuming a sale, his fraud was not "in connection with" the sale. This Court has interpreted the "in connection with" language of Section 10(b) broadly to reach "deceptive practices *touching* [the] sale of securities * * *." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971) (emphasis added). The required nexus is clearly satisfied where, as here, a sale is essential to the

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Section 10(b) for the alleged breach of a fiduciary duty based on non-disclosure. 593 F.2d at 63. By contrast, here petitioner had no discretion over Spitters' margin account at Dean Witter, and clearly exceeded any discretion that he had over the Congregation's account (see note 4 and 6, *supra*). Moreover, unlike the trustee in *O'Brien*, petitioner engaged in affirmative concealment of his securities transactions.

success of a scheme to defraud. The court of appeals correctly held that it is sufficient that petitioner was "engaged in fraud" when he pledged his customer's securities (Pet. App. A-11). In any event, petitioner's argument (Pet. 39-42), that some "causal connection" between his deceptive conduct and the sale of a security is required, was plainly satisfed in this case. But for petitioner's active concealment of the nature of his actions, neither Dean Witter nor the customers would have permitted petitioner to pledge the securities that were involved in this case.

3. Finally, there is no merit to petitioner's suggestion (Pet. 13-16) that his fraudulent activity is a matter of concern only to the states, and that the decision below will lead to a flood of cases in federal court that should be decided by state courts. Regulation of the fiduciary relationship between securities brokers and their customers cannot be described as a concern solely of state law. Such regulation is essential to the federal effort " 'to achieve a high standard of business ethics * * * *in every facet of the securities industry.*' " *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979), quoting *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-187 (1963) (emphasis in original).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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